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Bond Premiums and the Natural Real Rate of Interest

by: Craig S. Hakkio and A. Lee Smith

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No, it's not pirate lingo, it's the natural real interest rate, or r^* . It turns out that bond premiums are an important determinant of r^* .

The natural real rate of interest—the level of the real federal funds rate most consistent with the Federal Reserve's statutory mandates of maximum sustainable employment and stable prices—is a key guidepost for monetary policy decisions. But most approaches used to estimate the natural rate, also known as r^* , have not kept pace with the Federal Open Market Committee's rapidly expanding set of monetary policy tools. Craig S. Hakkio and A. Lee Smith introduce two approaches to estimating the natural real rate that account for the broad state of U.S. financial conditions as well as the additional accommodation that unconventional policies provide. Their results suggest bond premiums are an important determinant of the natural real rate of interest. Specifically, their estimates of r^* from both approaches suggest a reduction in bond premiums increases the natural real rate.

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Author



A. Lee Smith

Senior Vice President

Andrew Lee Smith is a Senior Vice President and Economist at the Federal Reserve Bank of Kansas City. In this role, Lee has oversight of macroeconomic research and serves as an advisor on monetary policy matters. Lee's research has focused on the effects of expanding and unwinding the Federal Reserve's balance sheet, the impact of forward guidance on financial markets and the economy, and, more generally, how central bank communication can influence expectations and economic conditions. Prior to joining the Bank in 2014, Lee received a Ph.D. in economics from the University of Kansas. He also holds a B.A. in economics and mathematics from Drury University in Springfield, Missouri.
